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Defined Contribution Institutional Investment Association

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Managed Accounts
A Primer

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EXECUTIVE SUMMARY

This is the first in a series of four papers that DCIIA will publish on managed accounts. This primer is meant to provide an overview of the key aspects of managed account programs today. It includes a review of the basics of managed accounts, a summary of their usage over time, a description of how they can be offered, and considerations for determining if they are right for a particular defined contribution (DC) plan, and if so, in what ways.

This Managed Accounts series reflects DCIIA's commitment to providing timely and relevant information on the qualified default investment alternative (QDIA) universe. Our goal is to be a trusted resource for plan sponsors in pursuit of plan and investment designs that will deliver the best possible retirement outcomes for participants.

TABLE OF CONTENTS

INTRODUCTION

This is the first in a series of four papers that DCIIA will publish on managed accounts. The goal of these papers is to assist plan sponsors and their consultants with a detailed understanding of managed account services and how they can be evaluated and monitored. This primer is meant to provide an overview of the key aspects of managed account programs today. It includes a review of the basics of managed accounts, a summary of their usage over time, a description of how they can be offered, and considerations for determining if they are right for a particular defined contribution (DC) plan, and if so, in what ways. Subsequent papers in this series will explore:

- Due diligence considerations and the requirements for implementation of managed accounts, as well as a comprehensive sample request for proposal (RFP).
- Conversations a fiduciary committee may have internally and/or with its consultants when being educated on managed accounts and/or when considering the addition of a managed account into the DC plan.
- An overview of the asset allocations submitted by managed account providers that participated in a DCIIA study, highlighting important areas for plan sponsors to consider when comparing managed account providers.

Managed accounts have attracted a lot of attention from fiduciaries attempting to evaluate these products. A key challenge is that the evaluation process for managed accounts is typically different than that used when considering other investment-related products, because managed accounts are a service product rather than a particular investment fund. Accordingly, plan sponsors must rely on different criteria when considering the adoption and monitoring of managed account services and providers. Furthermore, there is a lack of widely available risk-adjusted performance, which is generally the benchmark used for evaluating a fund. Sponsors need to ensure that they review and understand the managed account provider's investment fund selection methodology, portfolio risk levels, fee structures, various factors that impact personalization, and to what degree those factors impact participant portfolios and their potential to deliver effective outcomes.

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BASICS OF MANAGED ACCOUNTS

A managed account is a customized discretionary portfolio managed for a DC plan participant and is generally, but not always, provided by an investment manager selected by the plan to serve as a (3)(38) fiduciary. The value proposition for a managed account is that a personalized portfolio—based on a participant's demographic information, such as age, income, portfolio balance, and other personalization inputs—will provide an optimized outcome, after fees. This personalized data can be obtained from both the participant and the plan's recordkeeper. The funds utilized to construct a managed account portfolio are typically the same funds available to participants on the core menu. Also, typically, the entity creating the managed account portfolio is a fiduciary that charges a basis point fee (assessed against the participant's account balance) for the service. Beyond portfolio allocations, additional services offered by managed account programs may include guidance or advice as an ERISA 3(21) investment advisor to the plan sponsor on optimal savings and retirement readiness projections, or education for its participants, although these services vary by provider. In some cases, the investment advisor also offers management of assets outside the DC plan, under an arrangement made with the individual participant.

There are a variety of reasons a plan sponsor may choose to make a managed account solution available to participants. One commonly cited reason is the desire to offer a more personalized investment solution to participants who are actively seeking advice. While the "core" service of managed accounts is related to investment portfolio management (which includes both determining the appropriate risk level and the composition of the underlying portfolio based on the data inputs provided), additional services may include:

- Savings rate guidance
- Social Security recommendations
- Projections on retirement readiness
- Guidance on the potential purchase of annuities
- Tax-efficient investing strategies (e.g., asset location or tax loss harvesting)
- Access to a financial advisor
- Retirement distribution planning/withdrawal strategies
- Tools that help investors better assess their financial position (e.g., budgeting, cash flow statements, balance sheets, goal analysis)

Key Terms: Origins and Meanings

The terms "3(21) investment advisor" and "3(38) investment manager" have their origins in the Employee Retirement Income Security Act of 1974 (ERISA). Even though Section 3(21) fiduciary status applies to both discretionary and non-discretionary investment advisors:

- The industry uses the term 3(21) investment advisor generally, to describe a consultant, advisor or other financial professional who provides non-discretionary fee-based investment advice to a participant.
- The industry uses the term 3(38) investment manager to describe an investment professional who manages a participant's assets on a discretionary basis.

For example, in the context of a participant-directed individual account plan, a managed account provider may act as a "3(38) investment manager" with discretion on how the participant's account balance is allocated amongst the plan's investment options, while a managed account provider acting as a "3(21) advisor" would not make the decisions for the participant. Instead, a 3(21) advisor provides advice to the participant on a topic and the participant then accepts or rejects the advisor's recommendations.

Source: Morgan Lewis & Bockius, LLP

While a financial planner not associated with the plan can provide many of these services, two unique features of managed account providers are their ability to:

1. Act as an ERISA 3(38) fiduciary with respect to discretionary asset management provided on behalf of the plan participants: and
2. Deliver competitively priced advice to plan participants due to technology and scale.

A managed account provider can often be viewed as an online, in-plan financial advisor held to an ERISA 3(38) fiduciary standard. Managed account providers generally include online technology in delivering institutional-quality asset allocation to DC plan participants.

ADOPTION OF MANAGED ACCOUNTS

The availability of managed accounts in DC plans has steadily increased over the last decade, from 6% of plans in 2005 (before the Pension Protection Act [PPA] was passed), to 59% of plans in 2019.[1] The increased presence of managed account services on plan platforms is consistent with the evolution of customization within the institutional retirement landscape, a trend that DCIIA first identified in 2011 and has subsequently explored in depth over the years.

While availability has widened, utilization remains low, with managed accounts capturing 3.6% of total DC assets: $271 billion of the $7.6 trillion total (up from $108 billion in 2012), and used by 2.9% of total DC participants (3.1 million of 107 million total), according to Cerulli.[2]

In 2006, the PPA named managed accounts as one of three QDIA options for DC plans, the other two being target date funds (TDFs) and balanced funds. Of these three QDIAs, TDFs are by far the most popular, used by approximately 85% of plans. Since 2014, managed account usage numbers have fluctuated somewhat, but generally are in the 2% to 4% range in regard to being used as a default investment.[3]

It should be noted that plans offer advice products other than managed accounts. In fact, 74% of plans offered non-discretionary online advice in 2018.[4] Such advice and the services provided by managed accounts are not mutually exclusive, but such advice can be viewed as similar. Typically, online advice is a point-in-time recommendation that may be generalized (e.g., at the asset class or individual investment level) and is available at little or no cost to participants. Managed account providers typically also have an online, point-in-time advice component using the same investment methodology, but will then go one step further and provide an ongoing service, one that implements the investment decisions and responsibilities for the participant and charges a fee based on the participant's DC plan account balance.

The managed account space has been dominated by a few industry providers, with the largest four providers representing 97% of assets.[5] This is due in large part to managed account connectivity to recordkeeping platforms. A plan sponsor may decide that managed accounts make sense as an option for plan participants but will be limited to which managed account provider it can select based on that recordkeeping connection. Asset concentration among top providers also prevails in other QDIA products, as the top four TDF providers accounted for 79% of assets as of 2018.[6]

How Managed Accounts Can be Offered

As described earlier, a managed account can be offered as an additional service or it can qualify as the plan's default investment option.

1. **The managed account as an investment service (opt-in implementation)** – With this option, plan sponsors make the managed account service available to all participants, whereby each participant can elect to opt in and pay for the managed account services. Once managed accounts have been implemented in the plan, any participant can elect to use or cease to use the managed accounts at any time. Recently some plans have made managed account services available only to certain cohorts, such as those aged 55 and older.

   Among plans offering managed accounts, the vast majority (92.9%) implement it as an opt-in service, according to Callan. When managed accounts are available as an opt-in service, utilization is typically relatively low, around 7%, but can vary significantly across plans.[7]

2. **The managed account as the plan's QDIA (opt-out implementation)** – If adopted as a standard auto-enrollment QDIA, plan sponsors would default all new employees into the managed account service when they are first eligible to join the plan. Plan sponsors can consider doing a complete QDIA re-enrollment by pushing all existing (and new) participants into the managed account service. In both scenarios, an opt-out feature is required, whereby the participants can opt out of the managed account service and instead either select or retain their previously selected investment choices, respectively. An additional approach that is emerging is to consider adopting a managed account as the QDIA for a particular subset of participants, effectively adopting two QDIAs for the plan.

   Not surprisingly, in the few cases when managed accounts have been adopted as the plan's only QDIA and implemented under auto-enrollment, participant utilization of the managed account service is directionally consistent with other DC plan defaults, such as TDFs, with approximately 75% of participants remaining in the program. This suggests that, as with auto-enrollment of all kinds, the way managed accounts are offered to participants (i.e., opt-in versus opt-out) can reasonably be expected to have a significant impact on usage.[8]

In addition to evaluating the cost associated with the managed account services, there are a number of considerations that a plan sponsor should be aware of when evaluating whether to offer a managed account to participants as an additional service or as the plan's QDIA, which include those considerations summarized below:

OPT-IN IMPLEMENTATION	OPT-OUT IMPLEMENTATION
• Participants who actively select a managed account may be more motivated to utilize its full features, which better enables the service to provide additional value	• The potential value-add of a managed account can vary, depending on a participant's situation and engagement
• Participants seeking additional help bear the costs of the service	• Not every participant will derive value from the service, given the additional cost and depending on the degree to which asset allocations are customized, where there is limited input and/or other data provided
• Not all participants who may benefit from the managed account service may elect to opt into the service	• Collaboration between the plan sponsor and the managed account provider is often critical to drive participant-level engagement, which will optimize the value of the service but requires additional plan sponsor resources and time
• Lower costs may be negotiated as participation and assets increase over time	• Costs will likely be lower than an opt-in structure (as the plan can leverage its full population when negotiating fees)

As with any plan design change, the primary question is whether the expected benefits of the managed account will outweigh the costs. If the plan decides to make a managed account service the default for all or a group of its participants, another question is whether the potential benefits are enough to justify replacing the current QDIA option. The answers to these questions are likely to differ by plan, and by the population group being considered, as well as the way this decision might be approached; therefore, plan sponsors should seek additional guidance from their investment consultant in order to make an informed decision.

INNOVATIONS IN MANAGED ACCOUNTS

Innovations in ways to offer managed accounts continue; for example, under the "managed account as QDIA" model, two recent developments have been the "hybrid" default solution and the "personalized portfolio assignment":

In a **hybrid default structure** (also referred to as a "dynamic QDIA") more than one default investment is used for a given plan—typically, a combination of TDFs and managed accounts. Early iterations of these products have used age as a variable to determine the appropriate default, with younger participants (e.g., those under the age of 45) being defaulted into TDFs and older participants being defaulted into managed accounts. As is required with any default action, proper notice is given to affected participants that they have the option to switch to the managed account or to stay with the TDF. The plan's recordkeeper then needs to be able to administer the switch at the stated age. The idea of a plan's adopting multiple QDIAs is too new to evaluate whether a newly defaulted participant would opt out as a result of a higher fee or any other aspect of the personalized portfolio management.

With a **personalized portfolio assignment** process, participants are placed in one of several different glide paths, based on demographic data provided by the plan sponsor (e.g., whether the participant is covered by a pension). While this approach is not considered a full managed account solution, it does incorporate some level of customization by considering additional data, beyond just number of years to presumed retirement, in the default determination process.

It should be noted that both of these structures are complex and all aspects should be carefully evaluated.

ARE MANAGED ACCOUNTS RIGHT FOR YOUR PLAN?

There are several factors to consider when determining if managed accounts are right for a particular DC plan. As stated at the outset of this paper, fiduciaries considering managed accounts should be confident that they have thoroughly evaluated the products prior to their adoption, and that they can monitor their service on an ongoing basis. This can be challenging, given the differences in how managed accounts are evaluated versus other investment products typically found in DC plans, and the relative complexity of managed accounts when compared with TDFs. Some of the key considerations and questions to ask are below.

Addressing Plan Goals

Like any change being contemplated by a plan sponsor, managed accounts should align with the overall goals of the plan. There are a variety of initiatives, all differing in effectiveness, cost, and required fiduciary oversight, that can help address plan goals. Therefore, it is important for plan sponsors to clearly articulate what they are trying to achieve. For example, plan design changes such as automatic enrollment and auto-escalation can help improve participation and increase savings rates, whereas a re-enrollment into a plan's TDF can improve the typical asset allocation of plan participants. Managed account services may assist participants with identifying more optimal savings rates and appropriate asset allocation and may help with retirement planning. Considering managed account services alongside other QDIA alternatives can be a useful practice in better understanding the various paths to achieving the plan's goals and objectives.

Understanding Employee Populations

This section reviews how participant age can be a primary consideration in the managed account evaluation process. Demographics unrelated to age are also discussed.

Examining Participant Age Demographics

One way for plan sponsors to gauge the potential benefits of a managed account service is to examine the demographics of their participant base. A relatively simple place to start is to look at the age distribution of their participants. While this type of analysis can be applied in several different ways, there is a widely accepted premise that participants approaching retirement with more varied circumstances regarding accumulated wealth, a shorter remaining contribution period and both income and asset preservation/growth goals stand to benefit more from a managed account program than do younger participants with less wealth, a longer active contribution period, and a primary goal of accumulation.

As participants age, they are more likely to have held multiple jobs and, by extension, more likely to have assets spread across more than one account. Furthermore, older participants have generally experienced a greater number of significant life events, like marriage, starting a family, or the loss of a parent. Each of these events can add complexity to the investment decisions one needs to make.

A managed account program can consider an investor's total portfolio (including assets in and out of the plan) when developing asset allocation strategies. If the older participants in a plan are more likely to own additional assets, perhaps they could benefit more than younger participants from engaging with a managed account service. Moreover, older participants may welcome the additional services provided by some managed account providers in terms of withdrawal advice and guidance. This structure may also become more meaningful as more plan sponsors actively engage in building out a "retirement tier" in their investment lineups on which the managed account could then draw. In any case, it is important for participants using the service to maintain ongoing engagement with it in order to realize its full value. This point should be communicated to participants regularly.

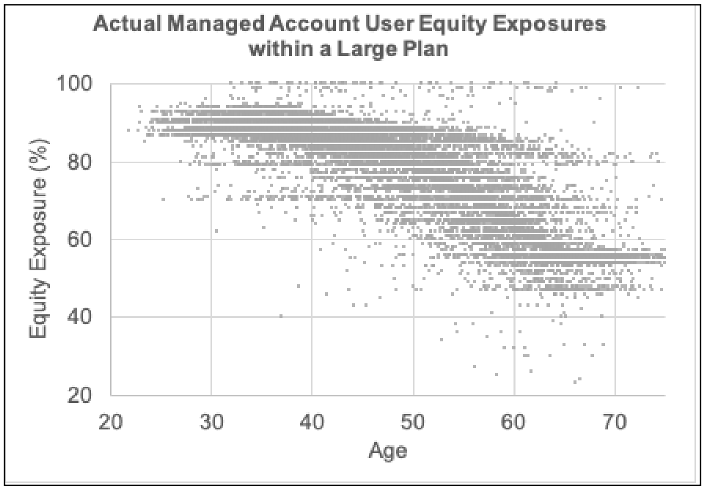
Likewise, a plan with a participant base skewed toward younger participants might consider their similar risk capacity, one based on their high remaining earnings power (human capital) and relatively low savings (financial capital). One possible way to determine if the broader market sees the risk capacity of younger participants as similar is to examine the dispersion of allocation strategies across the longer dated vintages among multiple target date series.

In the Appendix, we display equity exposure across the 2050, 2055 and 2060 vintages for off-the-shelf target date programs in the marketplace. These statistics imply that the dispersion of allocation strategies among individuals 35 years of age and younger is low. Although this represents only one way of gauging the potential appropriateness of a custom asset allocation strategy, it seems consistent with the notion that investors possessing a lot of remaining earnings power and not a lot of savings share a similar risk profile, which would lead to similar allocation strategies, thereby potentially reducing the benefit of any customization service.

Examining Other Participant Demographics

While asset allocation and risk tolerance vary at the individual level, auto-enrollment has been premised on an acceptance that there can be commonalities among employee populations that make a common investment type beneficial. To build on this basic idea, some population demographic characteristics beyond age can make one investment solution directionally a better fit for them than another. For example, companies where employees tend to be relatively similar, such as those where wages are collectively bargained, may be better served with a TDF than a managed account because the customization that drives the higher managed accounts cost is not needed. Alternatively, more diverse organizations with heterogeneous workforces might be better served with managed accounts because the customization has the potential to add more value and justify the higher cost. However, these characteristics alone do not definitively suggest that one approach is more optimal than the other.

Medical practices, law firms and engineering firms are classic examples of firms that have distinct employee populations within their organizations. Doctors and nurses, like law partners and paralegals, for instance, tend to have very different profiles when it comes to benefits, savings profiles and human capital. These differences could warrant the consideration of more personalized asset allocations. The chart below demonstrates how equity exposures of actual managed account users in a large plan can vary with personalization.



Source: *Edelman Financial Engines*. Reflects actual equity allocations by participant age, as of June 30, 2019, among managed account users for a single plan sponsor client.

INVESTMENT MENU IMPLICATIONS

Since a managed account service typically uses the investment options available on a plan's core menu, it is important to understand how a managed account provider's asset allocation philosophy and approach will utilize the options on the plan's menu. This is particularly important when the managed account service is implemented as the plan's QDIA.

Because the usage of investment options is at the discretion of the managed account provider, it is possible for a managed account provider to only use a subset of the investment menu. What the managed account provider offers participants depends on how it views and models the plan's investment options, which may result in selections that differ from the plan sponsor's intention or the plan's investment policy. Some of the key investment menu implications to be aware of include:

- Approach to and usage of active versus passive funds
- Inclusion or exclusion of company stock
- Ability to model and incorporate multi-asset investment options
- Holdings-based versus returns-based data usage in asset allocation modeling, and availability of required information
- Ability to model and use funds or strategies with limited historical performance (e.g., the implementation of a new separate account or white label fund)

Depending on the total assets invested in the managed account program, it is also possible to see larger shifts in investment option balances when the managed account provider makes a change. If a plan uses commingled funds and separate account vehicles, it is important to understand any impact a shift in assets may have on fund/account minimums or tiered-fee scales, as the managed account provider adjusts their exposures over time.

COST CONSIDERATIONS

As with all plan changes, cost is a key consideration. Managed accounts typically carry a service fee that is incremental to the fees of the individual fund options in the plan.

Fiduciaries are responsible for evaluating and determining if the fees that participants pay from plan assets are both reasonable for their value as well as compliant with ERISA, as it relates to paying for additional plan services. Since programs are priced differently, plan sponsors should understand how fees are structured, and how favorable or unfavorable a fee structure is, based on the demographics of their participants. A "flat fee" structure may be less desirable for younger participants with lower balances because the fee will be a greater percentage of their assets. On the other hand, older participants with more complicated financial lives, ones that can include more outside assets, might find it easier to justify paying the additional fee, which is charged on assets held only within the plan.

A plan sponsor also should understand the potential cost of an opt-in vs. opt-out structure. Nearly all managed account providers offer a discounted fee for opt-out programs, due to the economies of providing the services to a greater percentage of a firm's employees. That said, the size of the opt-out discount does vary by provider and may be affected by other factors such as the overall size of the plan. For example, a managed account that would cost 45 basis points as an opt-in could be reduced to 25 basis points or lower as a default. Lastly, use of a managed account as a default may also affect underlying fund fees as the managed account provider moves participant assets between the funds in the plan. Finally, care should be taken to consider the cost model in light of the practical range of services expected to be provided across a variety of employee engagement levels.

For further reading, please visit the DCIIA Resource Library's **Investment Options and Best Practices** and **Plan Design Matters** topics.

CONCLUSION

As fiduciaries, plan sponsors have a responsibility to act in the best interests of their participants. This has always been true when selecting an ERISA 3(38) investment manager and remains so as plan sponsors explore including more services and solutions to help their participants have better outcomes. Managed accounts represent one such potential option. While the use of managed accounts in DC plans today is relatively small, interest (and assets) in managed accounts are on the rise, albeit at different paces. Managed accounts may have the potential to add value across a number of dimensions (i.e., beyond their intended mandate of building efficient and appropriate portfolios), but they also bring an additional layer of costs to the participant. Plan sponsors should therefore carefully consider whether a managed account program is suitable for their plan and its participants, and if desirable, should prudently select its managed account provider, all while working with their investment consultant, recordkeeper, and ERISA counsel (if applicable). Further discussion of the advantages and challenges associated with managed accounts can be found in the GAO report on the subject.[9] Plan sponsors should also consider the impact of the various implementation options and of the required monitoring of the service.

In future papers in this series, we will look at due diligence and implementation considerations. We will also explore the potential benefits and challenges of managed accounts from the viewpoint of a fiduciary committee deciding between managed accounts and TDFs as a plan's default option. Lastly, we will look at the results of a request to managed account providers to provide recommended asset allocations for a variety of different participant profiles. We believe these results will highlight the more important personalization factors for managed accounts and where managed accounts might be most likely to add value.

Endnotes

[1] Callan Institute, "2019 Defined Contribution Trends Survey," 2019

[2] Cerulli Associates, "The Cerulli Report-U.S. Defined Contribution Distribution 2018: An Update on Managed Accounts in DC Plans," 2018

[3] Callan survey, 2019

[4] Callan survey, 2019

[5] Cerulli Associates, "The Cerulli Edge Retirement Edition," 1Q 2019

[6] Morningstar, "2019 Target-Date Fund Landscape," 2019

[7] Alight Solutions, "The Impact of Managed Accounts and Target Date Funds in Defined Contribution Plans, 2006-2017," 2018

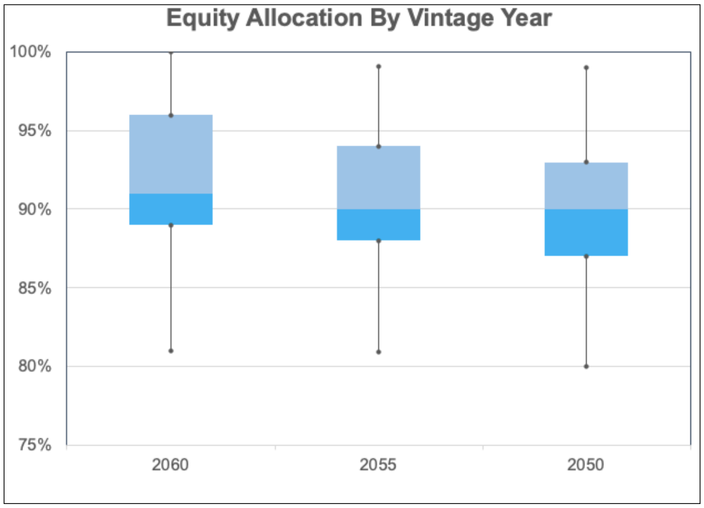
[8] Blanchett, David, Daniel Bruns, and Nathan Voris, "The Impact of the Default Investment Decision on Participant Deferral Rates: Managed Accounts vs Target-Date Funds," Morningstar, 2016

[9] GAO, "401(k) Plans: Improvements Can Be Made to Better Protect Participants in Managed Accounts," June 2014

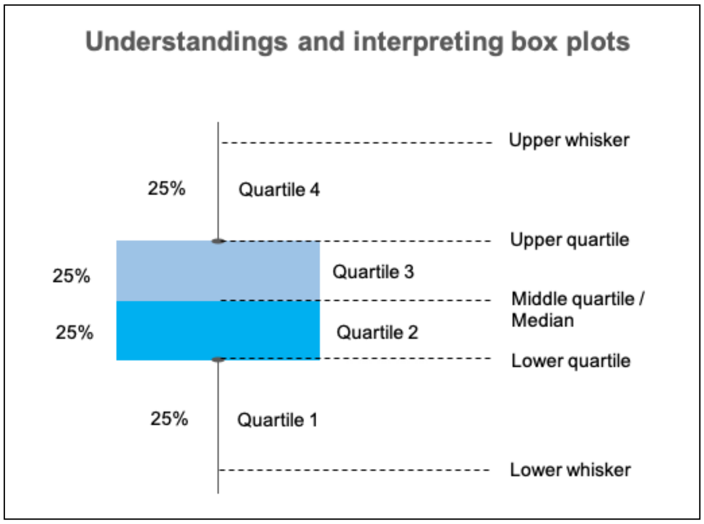
APPENDIX

Target Date Funds' Equity Allocations Across Longer Dated Vintages

The Box Plot is a graphical representation of the distribution of observations. The median observation is where the 2nd quartile and 3rd quartile meet (at the border of the light blue and dark blue boxes). The upper and lower whiskers represent scores outside the middle 50%. Extreme observations in the upper and lower 5% of the dataset have been excluded from the chart. See the second box at right for further details on interpreting this plot.



Data Source: Morningstar Direct



ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of America's workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA's diverse group of members include investment managers, consultants and advisors, law firms, record keepers, insurance companies, plan sponsors and other thought leaders who are collectively committed to the best interests of plan participants. For more information, visit: www.dciia.org.

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